UHERO
THE ECONOMIC RESEARCH ORGANIZATION
AT THE UNIVERSITY OF HAWAI‘I

UHERO FORECAST PROJECT

KAUAI ECONOMIC OUTLOOK SUMMARY
PREPARED FOR THE COUNTY OF KAUAI

KAUAI GROWTH BUILDS BEYOND TOURISM

JULY 2, 2015

UHERO

THE ECONOMIC RESEARCH ORGANIZATION AT THE UNIVERSITY OF HAWAIʻI

KAUAI ECONOMIC OUTLOOK SUMMARY
PREPARED FOR THE COUNTY OF KAUAI

CARL S. BONHAM, PH.D.
Executive Director

BYRON GANGNES, PH.D.
Senior Research Fellow

PETER FULEKY, PH.D.
Economist

ASHLEY HIRASHIMA
Graduate Research Assistant

JAMES JONES
Graduate Research Assistant

RESEARCH ASSISTANCE BY:
Adele Balderston

2424 MAILE WAY, ROOM 540 • HONOLULU, HAWAII 96822
(808) 956-2325 • UHERO@HAWAII.EDU

EXECUTIVE SUMMARY

After a mixed 2014, things are looking up for Kauai. Tourism is positioned for several more years of incremental growth before topping out in the face of tightening capacity constraints. Now that housing markets have firmed, construction should finally begin its turnaround. The improvements we have seen in labor markets set the stage for broad growth in income for the Island's residents.

- External factors will support Kauai growth, including ongoing US expansion and lower energy prices. On the negative side, the strength of the dollar will act as a drag on spending by international visitors.
- Visitor arrivals have started off the year well. Increased direct airlift from the US mainland is supporting moderate US market gains, and there has been a surprising jump in visitors from international markets other than Japan. Growth in the total number of visitor days will exceed 3% this year, decelerating thereafter.
- The still-moderate levels of hotel occupancy on Kauai suggest there is room for additional visitors over the next several years. At the same time, there are mounting concerns that the high number of existing visitors is increasingly stressing the Island's infrastructure.
- Labor market conditions have made steady strides, with the unemployment rate edging down to 4.6% recently. Moderate job growth is expected across a range of industries.
- Despite a teasing upward blip in 2013, there has been no recovery in Kauai's construction industry. Permitting for new residential construction has been on a shallow upward path, but job losses resumed last year. Better housing market conditions and planned commercial construction will begin to push construction employment upward, although job counts will remain far shy of the levels they reached in the 2000s boom.
- Combined with increases in the minimum wage, the tightening of labor markets will support growth in wages sufficient to outpace inflation and raise real household incomes. Real income growth on Kauai will peak at 3.3% in 2016, before falling back as employment growth eases toward trend.

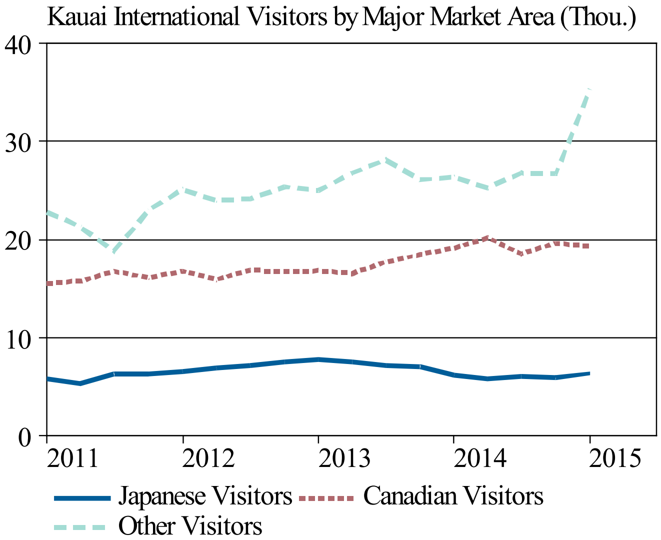
KAUAI MAJOR ECONOMIC INDICATORS
YEAR-OVER-YEAR % CHANGE

	2012	2013	2014	2015	2016	2017
Visitor Arrivals	7.2	2.7	-0.1	3.8	3.7	1.9
U.S. Visitor Arrivals	6.4	2.0	-0.3	3.5	3.4	1.7
Japan Visitor Arrivals	18.4	5.5	-19.0	3.1	2.7	4.2
Other Visitor Arrivals	9.9	6.4	4.1	5.5	5.3	2.4
Payroll Jobs	1.6	3.1	0.7	1.3	2.1	1.1
Inflation Rate, Honolulu MSA (%)	2.4	1.8	1.4	1.1	2.1	2.5
Real Personal Income	2.1	2.2	2.0	2.5	3.3	2.4

Figures for 2015 - 2017 are forecasts.
Figures for 2014 county income are UHERO estimates.

Kauai's economic performance last year was uneven. Although the number of visitors was flat, their total spending rose. Payroll jobs ticked up less than 1%, and despite a hoped-for recovery, the construction sector actually shrank. This year looks to see stronger growth. Tourism gains are picking up, and despite long-standing infrastructure concerns, we expect several years of moderate additional expansion. Construction appears poised for a turnaround now that housing markets have firmed. Overall, moderate job and income gains will continue, tapering as we move toward the latter part of the decade.

External conditions will be broadly supportive of growth, with some important exceptions. Despite weakness at the start of the year, expansion in the US economy will continue. The negative impact of federal sequestration is waning, even if there is little prospect of significant growth in either federal or state and local government spending. The greater than 50% drop in oil prices since the middle of last year has lowered prices for electricity and gasoline, creating positive effects across the entire local economy. And lower fuel costs will also benefit tourism. Visitors who face lower energy costs at home are likely to spend some of those savings on vacations. The benefit to airline bottom lines will create incentives for airfare competition to ensure that the planned growth in seat capacity is filled. Offsetting some of the benefits is the strong dollar. Since the beginning of 2013, international visitors to Hawaii have dealt with increasing costs of a Hawaii vacation ranging from 20% to 30% due to currency movements alone.



INTERNATIONAL VISITORS FROM MARKETS OTHER THAN JAPAN ARE MORE THAN 17% HIGHER THAN IN THE SAME PERIOD OF 2014

At the same time, the strong dollar may tempt potential US visitors to choose a trip to Canada, Mexico, or Europe.

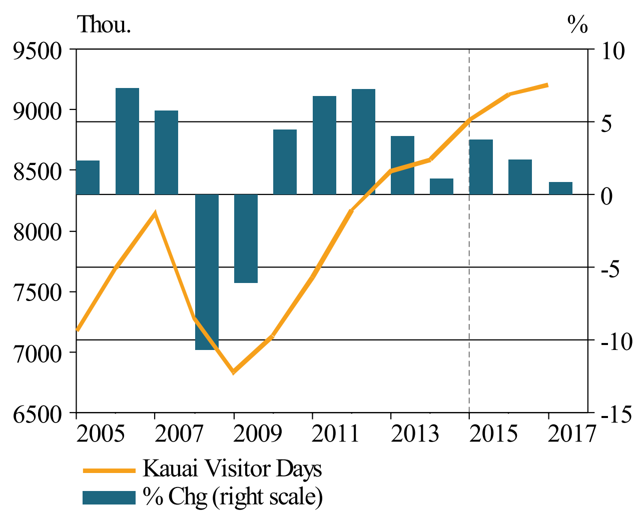
Cautious spending by US consumers last year resulted in relatively limited tourism gains across the four Hawaii counties, and depending on how you measure it, Kauai was at or near the bottom of the pack. There was no net change in the number of visitors to the Garden Isle, although a slight increase in the length of stay raised the number of visitor days by about 1% (Oahu was weaker, with a greater than 1% decline in visitor days.) Arrivals fell off a bit in the dominant US market, and Japanese arrivals plunged, although the latter represents a very small market for Kauai. Visitors from international markets other than Japan were up by mid-single-digits, but that was not enough to offset US market declines. Visitor spending rose more than 5%, roughly on par with the Big Island but well below spending gains in Maui County.

Kauai tourism gains will be a bit stronger this year than last. Improving visitor numbers began to emerge in the second half of last year, and figures for the first five months of 2015 generally continue that trend. US arrivals are up a little more than 4%, thanks in part to a 4.6% increase in direct lift from the US mainland. Japanese arrivals are also higher. Most interestingly, international visitors from markets other than Japan are more than 17% higher than in the same period of 2014, due to huge January numbers for visitors from Oceania. This market segment has grown to 16% of all Kauai visitors and can now have a significant effect on short-term tourism fortunes.

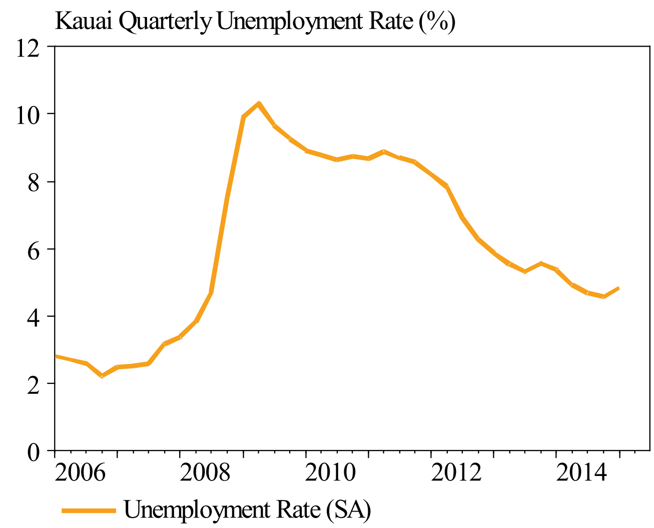
For the year as a whole, we expect the number of US visitors to expand by 3.5% and visitors from international markets other than Japan to rise 5.5%, exceeding last year's pace. While the cancellation of Island Air flights will reduce inter-island capacity—and leave the Island at least for now reliant on a single inter-island carrier—increases in direct flights from the mainland will help to offset capacity losses. For the upcoming summer travel season, direct airlift to Kauai from the US mainland is expected to be more than 6% higher than last year, with US Airways increasing service from Phoenix and United increasing service from San Francisco. Hawaiian Airlines will continue its seasonal direct service to Kauai from Los Angeles and Oakland. The total number of visitor days on Kauai will rise 3.8% this year, decelerating to 2.4% growth next year.

The still-moderate levels of hotel occupancy on Kauai suggest there is room for additional visitors over the next several years. This will push the occupancy rate above 73% by 2017. (Occupancy and room rate data are from Hospitality Advisors LLC.) Rising occupancy and generally busier conditions across the visitor industry will exert upward pressure on room prices both in hotels and other transient vacation rentals, as well as non-accommodation visitor expenses. Already, average hotel room rates on the Garden Isle have risen more than a third in nominal terms from their low point back in early 2010. (They remain below their previous peak in inflation-adjusted terms). To some extent, higher costs will act as a brake on visitor demand, bringing growth in visitor days below 1% by 2017.

Despite the availability of hotel rooms, there are mounting concerns on Kauai that the high number of existing visitors is increasingly stressing the island's infrastructure. Both parks and roadways are crowded even before the peak summer season,



HIGHER COSTS WILL ACT AS A BRAKE ON VISITOR DEMAND, BRINGING GROWTH IN VISITOR DAYS BELOW 1% BY 2017 causing hardship for tourists and residents alike. This could lead to a deterioration of the visitor experience and increased pushback from kamaaina. While the hotel surveys provide important information about accommodations use, they do not give a complete picture of overall capacity pressures. The fact that visitor days are in record territory but published hotel occupancey rates remain moderate implies an increased use of transient rentals that are not counted in occupancy surveys.



LABOR MARKET CONDITIONS HAVE MADE STEADY STRIDES, WITH THE UNEMPLOYMENT RATE EDGING DOWN TO 4.6% RECENTLY.

Following a statewide pattern, employment on Kauai jumped last year. These gains occurred early in the year, and the level of employment has dropped back a bit since. Still, labor market conditions have made steady strides, with the unemployment rate edging down from 5.4% at the start of last year to 4.6% recently. These gains have come despite the fact that more workers have entered the labor force as economic conditions have improved. This bodes well for wage and income growth as the expansion on Kauai continues. UHERO does not prepare unemployment forecasts for Kauai or the other Neighbor Island counties.

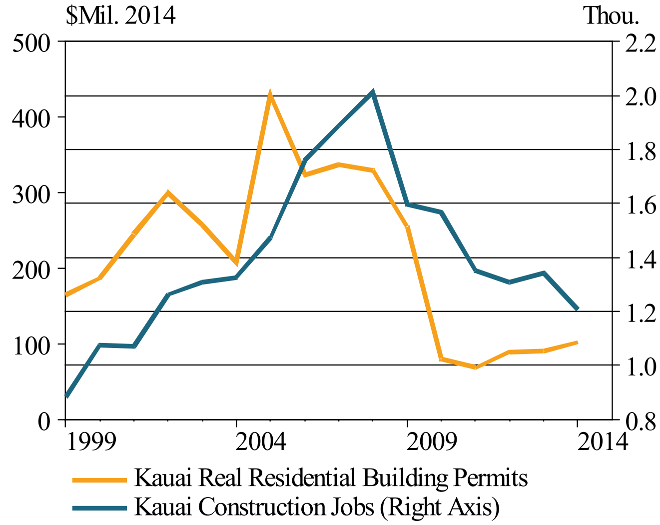
The growth in the payroll job count reported by businesses has been more restrained than employment: last year, the job base expanded by just 0.7%. The official survey data showed an outright decline in jobs at the start of the year, although we do not find these estimates credible and expect that they will be revised upward in the future. Considering visitor industry firming and recent improvement in other sectors, we expect job growth to accelerate a bit in coming months and to end the year up 1.3%. Jobs in the accommodation and food service sector will grow about 2% and accelerate above 3% in 2016. Wholesale and retail trade will experience greater-than-2% growth this year and next. Both sectors will stall as we move into the final part of the decade and tourism activity plateaus.

Healthcare faces particular challenges on the Neighbor Islands associated with the financial woes of the Hawaii Health Systems Corporation. Kauai County avoided significant net job losses last year, but it is likely that additional cuts will be made, as has occurred on Hawaii Island. Any contraction in the public system would have fallout for private healthcare as well. In any case, we expect that financial challenges will limit healthcare employment growth for the next couple of years. However, employment in the sector will necessarily rise over the medium term, and at a higher rate than the economy overall, as the county's population expands and ages. Jobs in our large "other services" category will return to growth more in line with the broader economy, after a weak 2014. We will see a welcome end to contraction in public sector employment, even if the upside potential is limited by ongoing budgetary pressures.

Note when interpreting sector growth rates for Kauai, that shifts of a percentage point or two may represent changes in employment of a couple tens of workers—or even fewer! In other words, for an economy the size of Kauai one does not want to read too much into volatile percentage fluctuations in job counts. Overall job growth on Kauai will pick up from 1.3% this year to just above 2% in 2016. Growth will decline to below a 1% annual rate by the end of the decade, in line with long-run trend growth of the Kauai County population and labor force.

Despite a teasing upward blip in 2013, there has been no recovery in Kauai's construction industry since it began to contract in 2008-2009. Job losses resumed last year, and the level of industry payrolls at the start of the year remains roughly half that at the peak seven years ago. We do think better times lie ahead, even if job counts will remain far shy of the levels they reached in the 2000s boom.

With lots of ups and downs, permitting for new residential construction has generally been on a shallow upward path for the last three years, but it remains at a very



DESPITE A TEASING UPWARD BLIP IN 2013, THERE HAS BEEN NO RECOVERY OF KAUAI CONSTRUCTION INDUSTRY JOBS.

low level. (Data on nonresidential permits are not available for Kauai County.) Even before adjusting for inflation, the $33 million in permits issued in the final quarter of last year was just 30% of the $69 million quarterly average for 2008. Still, median single-family home prices have recovered about half of the price decline experienced during the recession, and firming of the housing market will provide increasing incentives for new building.

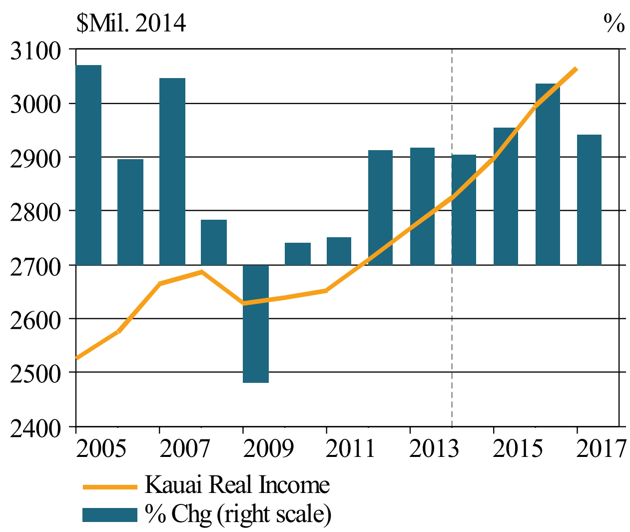
There is some residential development in the works. A&B has expanded building at Kukuiula in Poipu and expects to have 26 homes under construction this year, with another 20 breaking ground in 2016. The County's 550-unit Lima Ola workforce housing project on the West Side remains in the planning phase, but apparently could begin construction by 2017. The proposed 163-acre HoKua Place development has generated opposition because of traffic concerns in the already congested Kapaa area. The project is currently before the State Land Use Commission for an entitlement change from agricultural to urban use. Even if these various projects move forward, significant additional building would be needed to meet projected housing needs.

In the commercial arena, the Hokulei Village shopping center in Lihue will open its doors this summer, and the Kilauea Lighthouse Village center is in the permitting process, with construction expected to begin this summer. Earlier this year, the retail complex announced that the Sullivan Family of Companies, operators of Foodland, Food Pantry and the Kalama Beach Corporation, will open a supermarket as an anchor tenant for the development. In Poipu, an ABC shopping center across from the Kukuiuula Shopping Village will add additional retail, restaurants, and the second gas station in the area. In the healthcare sector, the West Kauai Medical Center Clinic is under construction in the Kukuiula Shopping Center, where a Longs Drugs Store is also being built. Once completed, the current clinic in Kalaheo will be closed.

Redevelopment of the Coco Palms resort, shuttered since Hurricane Iniki nearly a quarter century ago, is moving through the land use and permitting process. Princeville developer Jeff Stone recently sold a percentage interest to an overseas entrepreneur to develop 1,100 acres as part of the Resort's Phase II development. Still in the works is a resort at the former Hanalei Plantation site. Development of two potential resorts between the Kauai Coast Resort and the Courtyard Marriott could add to construction activity on Kauai.

After last year's 10% decline, we expect construction job losses to end this year, and for mid-single-digit growth to begin in 2016. Expansion of construction activity will bring the number of industry jobs to about 1,500 by the end of the decade, compared with about 2,100 at the previous peak in early 2008.

Inflation-adjusted personal income in Kauai County has been growing at a moderate pace since 2012, and we estimate that it expanded another 2% last year. Combined with increases in the minimum wage of $.50 in 2015 and $.75 in 2016, the tightening of labor markets will support growth in wages sufficient to outpace inflation and raise real household incomes. Higher incomes will in turn help to sustain a broadening out of economic expansion. Real income growth on Kauai will peak at 3.3% in 2016, before falling back as employment growth eases toward trend.



THE TIGHTENING OF LABOR MARKETS WILL SUPPORT GROWTH IN WAGES SUFFICIENT TO OUTPACE INFLATION.

For confidentiality reasons, income figures are reported only for the limited number of sectors on Kauai where there are a sufficiently large number of firms reporting. Among these, trends for income growth in coming years will largely follow those of the underlying growth in jobs. Income growth will turn strongly positive in construction next year, falling back as the cycle matures later in the decade. The accommodation and food service sector will see 3% or greater income growth for the next two years, tapering off when the industry reaches a plateau later in the decade. The pattern of near-term weakness and longer-term strength in healthcare jobs is also evident in our income forecasts for that sector. Finally, public sector income growth will be limited by the budgetary pressures we described above.

Kauai's economy will continue along its moderate growth path for the next few years. Incremental tourism growth will continue, winding down as we push up against the available accommodations capacity. In the mean time, the tourism growth we have already seen is taxing the Island's infrastructure, raising concerns for the health of the industry and the quality of life of residents. Beyond tourism, construction can be expected to (finally) play a role in Kauai's economic expansion. Overall growth will taper off as the economy converges onto it long-term trend growth path.

Aside from concerns about tourism carrying capacity, Kauai is exposed to the same set of external risks as other counties. At this stage in the national economic expansion, a chief concern is that policymakers could upend the recovery with inappropriate policy shifts. These could include overly-aggressive Federal Reserve tightening, a renewal of aggressive fiscal consolidation in the US, Europe or Japan, or a failure of Chinese officials to prevent a hard landing for their economy. Barring such developments, the Kauai economy appears set for several more years of satisfactory growth.

MAJOR ECONOMIC INDICATOR SUMMARY
KAUAI COUNTY FORECAST

	2012	2013	2014	2015	2016	2017
Non-farm Jobs (Thou)	28.2	29.1	29.3	29.6	30.3	30.6
% Change	1.6	3.1	0.7	1.3	2.1	1.1
Total Population (Thou)	68.4	69.5	70.5	71.1	71.7	72.4
% Change	1.0	1.6	1.4	0.8	0.9	0.9
Total Personal Income (Mil $)	2,623.8	2,728.4	2,824.4	2,928.6	3,090.6	3,244.7
% Change	4.6	4.0	3.5	3.7	5.5	5.0
Inflation Rate, Honolulu MSA (%)	2.4	1.8	1.4	1.1	2.1	2.5
Real Personal Income (Mil 2014 $)	2,709.1	2,767.8	2,824.4	2,896.1	2,993.1	3,065.0
% Change	2.1	2.2	2.0	2.5	3.3	2.4
Real Per Capita Income (Thou 2014 $)	39.6	39.8	40.1	40.8	41.7	42.4
% Change	1.1	0.5	0.7	1.7	2.4	1.5
TOURISM SECTOR DETAIL						
Total Visitors (Thou)	1,084.7	1,114.4	1,113.6	1,155.8	1,198.7	1,221.1
% Change	7.2	2.7	-0.1	3.8	3.7	1.9
U.S. Visitors	892.0	909.5	907.2	938.7	970.7	987.1
% Change	6.4	2.0	-0.3	3.5	3.4	1.7
Japanese Visitors	27.9	29.4	23.8	24.6	25.2	26.3
% Change	18.4	5.5	-19.0	3.1	2.7	4.2
Other Visitors	164.8	175.4	182.5	192.5	202.8	207.7
% Change	9.9	6.4	4.1	5.5	5.3	2.4
Avg. Length of Stay (Days)	7.5	7.6	7.7	7.7	7.6	7.5
Visitor Days (Thou Days)	8,170.5	8,496.9	8,590.5	8,914.9	9,128.1	9,207.8
% Change	7.3	4.0	1.1	3.8	2.4	0.9
Occupancy Rate (%)	68.8	69.2	70.3	71.7	73.0	73.2
Total Room Stock (Thou)	10.1	10.1	10.1	10.1	10.1	10.2
% Change	2.0	0.2	0.0	0.0	0.4	0.5

Note: Source is UHERO. Figures for 2015 - 2017 are forecasts.
Figures for 2014 Income are UHERO estimates. Figures for 2012 - 2014 room stock are UHERO estimates.